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May 24, 2004

David M. Eichenlaub
Division of Economics and Finance
State Corporation Commission
1300 East Main Street
Richmond, VA 23219

Re: Comments Concerning the Status of Competition -- Compliance by the State Corporation Commission with § 56-596.B of the Code of Virginia

Dear Mr. Eichenlaub:

Thank you for your letter of April 26, 2004, requesting comments regarding the status of competition in Virginia pursuant to Virginia Code § 56-596.B.[1] We respond on behalf of the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (collectively, "the Committees"), which consist of large industrial customers of Virginia Power and AEP-Virginia, respectively.

In response to last year's request of the Commission Staff for comments on the status of competition, the Committees observed that retail competition for generation services had failed to develop in Virginia. With the exception of a miniscule number of customers purchasing at prices above "capped rates" from a competitive service provider that had stopped offering the service to new customers, there was no retail competition at all. In terms of the existence of retail competition, we stated, little, if anything, had changed since the prior year.

That situation remains unchanged; electric competition still has failed to develop in Virginia. Restructuring in Virginia has fallen below expectations in other respects as well, as demonstrated by the attachments, which are intended to assist in evaluating progress to-date and prospects for future success. They include:

[1] Section 56-596.B of Virginia's Electric Utility Restructuring Act ("Restructuring Act"), Va. Code § 56-596.B, requires the Commission to recommend actions to be taken by the General Assembly, the Commission, electric utilities, suppliers, generators, distributors and regional transmission entities that the Commission considers to be in the public interest, including actions regarding the supply and demand balance for generation services, new and existing generation capacity, transmission constraints, market power, suppliers licensed and operating in the Commonwealth, and the shared or joint use of generation sites.

Attachment 1: Report Card on Virginia Electric Restructuring. The report card evaluates progress on key issues related to competition and restructuring. It reveals low or failing grades on the degree of retail competition, prospects for future customer savings from competition, customer rates during the transition to competition, the assessment of stranded costs and benefits (*i.e.*, whether power plants are worth more or less than book value), functioning of a regional transmission entity, and entry of independent power producers. The only "A" grade is utility earnings. While "capped rates" may provide incentives for reduced distribution and transmission reliability, that category receives no grade because it is still being assessed.

Attachment 2. Implications of Maryland Wholesale Bid Prices for the Future of Electric Restructuring in Virginia. Attachment 2 discusses the end of Maryland's capped electricity supply rates and the implications for Virginia. Capped electricity supply rates in Maryland end this summer, at the end of its transition period to retail competition. This will mean significant rate increases for Maryland electric customers. Maryland's experience does not bode well for prospects for customer savings from customer choice in Virginia. Retail customers of electric utilities in Virginia may remain on their respective utility's "capped rates" until 2011, so they will not be forced to pay market prices prior to that year.[2] If, however, such customers were forced pay market prices now, or if market prices in 2011 were similar to, or higher than, they apparently are now in PJM, it appears that, based on the wholesale bid prices in Maryland for standard offer service, electric rates for customers in Virginia would increase significantly.

Attachment 3: "Dominion: Capped Rates Equal Profit." DVP's earnings do not appear to have suffered as a result of restructuring. In fact, the SCC Staff's review last summer of DVP's 2002 earnings showed that it was overearning under "capped rates" and that its rates would be reduced by about 10%, or $400 million per year, if they were re-set based on its cost of service. Staff's review of 2003 earnings has not commenced. Recent amendments to the Restructuring Act extend DVP's capped rates through 2010 and freeze its fuel factor through June 30, 2007. Dominion Resources, Inc. ("DRI"), DVP's parent holding company, projects earnings increases of 5% to 7% in coming years, emphasizing the positive earnings impact of the recent amendments. Attachment 3 includes excerpts from DRI's presentation at a meeting in New York earlier this month between DRI officials and financial analysts and DRI's projected earnings increases. The excerpt indicates, *inter alia*, that enactment of the recent amendments "opens doors to increased earnings" for DRI. The attachment also includes a news article containing highlights of the meeting.

Attachment 4: Dominion Virginia Power's Request to Defer $280 Million of RTO Costs until 2011. Attachment 4 discusses DVP's request to the Federal Energy Regulatory Commission ("FERC") to defer $280 million in estimated RTO-related costs until after 2010, when its "capped rates" are scheduled to expire. DVP seeks the deferral in order to allow such

[2] The State Corporation Commission ("SCC") has the authority to terminate "capped rate" service prior to the end of 2010 if it determines that an effectively competitive market for generation services exists; however, in view of the progress of competition to-date and recent trends, such an SCC determination must be regarded as highly unlikely.

costs to be passed through to its customers. DVP represented to the General Assembly, however, that the recent amendments to the Restructuring Act, which extend its "capped rates" through 2010 and freeze its fuel factor until July 1, 2007, would benefit its customers by imposing on DVP the risks of new costs.

Attachment 5: Presentation of Jeff Pollock on behalf of the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates before the Commission on Electric Utility Restructuring. The Restructuring Act's wires charges and "capped rates" are intended to permit utilities to recover "stranded costs," *i.e.*, unrecoverable costs resulting from electric restructuring and competition in Virginia. On behalf of both Committees, Mr. Pollock presented the results of an analysis of stranded costs for DVP and Appalachian Power Company ("APCo") at a meeting of the General Assembly's Commission on Electric Utility Restructuring on November 24, 2003. (Attachment 5) He concludes that neither utility has any stranded costs and that, using a methodology for measuring stranded costs developed by Moody's Investors Service, AEP-Virginia and DVP would have stranded benefits of $874 million and $1.2 billion, respectively.

In formulating the Commission's findings regarding the status of competition, and in developing recommendations to the General Assembly, the Committees urge the Commission to consider the above comments. Electric restructuring has not worked so far in Virginia, and current developments do not bode well for its future success.

The Committees appreciate the opportunity to comment, and they look forward to continuing to assist the Commission in its response to the mandate contained in Virginia Code § 56-596.B.

Sincerely,

Louis R. Monacell

Edward L. Petrini

#678047

ATTACHMENT 1

REPORT CARD
VIRGINIA ELECTRIC RESTRUCTURING

ISSUE	GRADE	COMMENT
Degree of retail competition	F	Retail competition has produced no customer savings. A significant portion of Virginia's retail customers has had the legal right to choose since January 1, 2002. With the exception of one supplier that temporarily offered to sell "green" power at prices higher than the utility's capped rates, no supplier has offered to serve any retail customers.
Prospects for future savings from retail choice	D	Present market prices and trends suggest that American Electric Power's ("AEP's") customers have no prospect for future savings. Most of Dominion Virginia Power's ("DVP's") customers' prospects for such savings are dim in view of the likelihood of market prices exceeding capped generation rates by 2007.
Customers rates during the transition to competition	D	The State Corporation Commission ("SCC") Staff has issued a report indicating that DVP's rates are excessive by 10% and would be reduced by approximately $400 million per year if its rates were to be reset based on cost of service. Rates for customers of AEP may not have been excessive; however, 2004 amendments to the Act encourage unfair single issue rate increases for AEP without the ability to review the total cost of service to determine whether there are any cost reduction offsets. Rates of DVP's customers have soared since the Act the passed in 1999 because the Act has permitted rate "adjustments" to reflect increased fuel costs, and such costs have increased. A 2004 amendment to the Act freezes DVP's 2004 fuel factor through June 2007.

Utility earnings	A	DVP's annual report to the U.S. Securities and Exchange Commission ("SEC") shows that, on a total company basis, it earned more than 12 % on equity in 2003, down from more than 17% in 2002. DVP's holding company, Dominion Resources, Inc. ("DRI"), acknowledges now earning a 14% return on equity while emphasizing the importance of the recent extension of DVP's capped rates through 2010 and the freezing of its fuel factor until July 1, 2007, in its projected increases in DRI's earnings by 5% to 7% per year. Appalachian Power Company's Virginia electric business appears to have produced modest over-earnings during 2002 according to a recent SCC Staff report. Comparable earnings data for 2003 are not available.
Assessment of stranded costs and stranded benefits (whether power plants are worth more or less than book value)	F	The Virginia Electric Utility Restructuring Act ("Act") requires an assessment of whether utilities have over- or under-collected "stranded costs" (*i.e.*, costs rendered unrecoverable as a result of restructuring and competition). Despite the likelihood that no stranded costs exist, no such determination has been made. In fact, the existence of significant stranded benefits is more likely. According to the SCC Staff, since DVP's rates were capped by the Act effective July 1, 1999, DVP has earned more than $800 million toward stranded cost recovery, yet no stranded costs may even exist.
Functioning of Regional Transmission Entity (RTE)	D	The Act initially required utilities to join an RTE by January 1, 2001. Neither DVP nor AEP met the statutory deadline. In 2003, two years after the deadline, the General Assembly eliminated the original deadline and enacted a *new* deadline that requires utilities to join an RTE by January 1, 2005, subject to approval by the SCC. Both utilities now propose to join the PJM Interconnection, LLC ("PJM"), and they may join in late 2004 or during 2005. Neither has yet joined the PJM.
Entry of independent power producers	D	Generation owned or controlled by DVP and AEP continues to dominate Virginia's generation market. Independent power producers have built little new generation since passage of the Act. In fact, DVP has added to its generation fleet more MWs than the independents. As a result, market power has not been eliminated and possibly has been enhanced.
Reliability of distribution and transmission system	No grade yet	Capped rates could motivate Virginia utilities to decrease expenditures on reliability in order to increase profits and thereby reduce reliability. The SCC is collecting data on the number and duration of outages in order to assess trends.

ATTACHMENT 2

Implications of Maryland Wholesale Bid Prices for the Future of Electric Restructuring in Virginia

Maryland's frozen ("capped") electricity supply rates for electric utilities end this summer, at the end of its transition period to retail competition. The capped rates are based upon each utility's cost of providing generation, transmission, and ancillary services as part of its bundled service to its customers. Rates for standard offer supply service from the local utility to customers that do not choose a competitive service provider will replace the current capped electricity supply rates. Utilities have solicited and accepted bids from wholesale suppliers seeking to provide the new standard offer service, and have awarded contracts to wholesale suppliers based upon the bid prices. This change in Maryland from capped rates based upon the local utility's cost of service to standard offer service based upon wholesale suppliers' bid prices will result in significant increases in electricity rates to Maryland's citizens and businesses.

Rates for electricity supply in Maryland for larger industrial and commercial customers – defined as customers with a demand greater than 600 kW – could increase by 45% or more if such customers have received electricity supply service from their local utility and continue to do so. Total electricity bills could increase on the order of 35% or more. Such customers, moreover, will receive the option of standard offer service at a fixed price for only one year, until the summer of 2005. If they take electricity supply service from their local utility after the summer of 2005, their *only* standard offer service option will be an hourly priced service based upon locational marginal prices ("LMP") in the PJM Interconnection.

For a perspective on the level of the standard offer service electricity supply rates for larger industrial customers in Maryland pursuant to its wholesale bidding procedure, one can assume an industrial customer with an 88% load factor, with a demand above 600 kW, which takes service at primary voltage and uses 50% of its energy during on peak hours and 50% during off peak hours. Such a customer of Delmarva Power, for example, would pay an average of 6.909¢ per kWh for electricity supply, which includes generation, transmission, and ancillary services – that is everything but distribution service. In addition, such a customer must pay an "administrative charge" for receiving the standard offer electricity supply service. The charge is 0.65¢ per kWh.

In comparison, a similar Virginia Power customer presently would pay 4.057¢ per kWh, on average, for electricity supply service (generation, transmission, and ancillary services – that is, everything but distribution service) under capped rates. If such a customer were required to pay 6.909¢ per kWh for electricity supply service (and assuming it were required to pay no "administrative charge"), its rate would increase 70% for electricity supply service and 67% for electricity service overall.

A similar customer of AEP in Virginia presently would pay 2.6184¢ per kWh on average for electricity supply service (including generation, transmission, and ancillary services – that is, everything but distribution service) and 2.8772¢ per kWh for all services, including distribution service, under capped rates. In contrast, a similar customer of Delmarva Power in Maryland would pay 6.909¢ per kWh for electricity supply service, or 4.2906¢ per kWh more than what a

similar customer would pay AEP here. That is, the Maryland customer would pay 164% above what an AEP customer in Virginia would pay for electricity supply service and 140% above what that customer would pay in total rates.

Both Virginia Power and AEP propose to join PJM later this year. When such utilities are part of PJM, they will be part of the same PJM market and, presumably, market prices available in the service territories of AEP and Virginia Power will be similar to market prices in Maryland, which is also part of PJM.

The Staff of the Maryland Public Service Commission ("Maryland PSC Staff") filed a report, dated April 29, 2004, with the Maryland Public Service Commission describing the process and the results of the competitive wholesale procurement process used to determine prices for standard offer supply service at the end of Maryland's capped rate service. The Maryland PSC Staff found evidence of robust competition as shown by the large number of bidders, the large number of bids received, and a wide range of bid prices. The number of megawatts offered was nearly five times greater than the number of megawatts awarded. Of twenty five wholesale bidders, fourteen won contracts to provide some portion of the wholesale supply for full requirements service to Maryland customers who do not choose a competitive service provider.

The Maryland PSC Staff calculated the projected rate increases for residential and small commercial customers. Rates for standard offer power supply service for residential customers of PEPCO, for example, would increase 24% above capped rate power supply rates, and total bills (which include the distribution portion of the bill as well) would increase 15%. Residential customers of Delmarva Power in Maryland would see increases of 17% to pay for standard offer service power supply rates, as compared to capped rate power supply rates, and total bill increases of 11%.

In Virginia, retail customers of electric utilities may remain on their respective utility's capped rates through 2010, so they will not be forced to pay market prices prior to then.[1] If, however, customers in Virginia were forced to go to the market now, or if market prices in 2011 were similar to, or higher than, they apparently are now in PJM, it appears that, based on the wholesale bid prices in Maryland for standard offer service, customers in Virginia could see significant increases in their electricity costs. As suggested above, such increases for larger customers of Virginia Power might be on the order of 65% and for larger customers of AEP on the order of 140%.

The SCC and the General Assembly in Virginia should investigate Maryland's wholesale bid prices to assess their implications for Virginia's public policy of moving toward market based rates.

[1] The State Corporation Commission ("SCC") has the authority to terminate "capped rate" service prior to the end of 2010 if it determines that an effectively competitive market for generation services exists; however, in view of the progress of competition to-date and recent trends, such an SCC determination must be regarded as highly unlikely.

ATTACHMENT 3

Dominion: Capped rates equal profit

Gains of up to 7 percent a year expected under extension through 2010

BY GREG EDWARDS
TIMES-DISPATCH STAFF WRITER
Friday, May 7, 2004

Virginia's extended capped electricity rates should mean higher profit for Dominion Resources Inc., executives of the Richmond-based utility told Wall Street analysts yesterday.

The governor, attorney general and boosters including Dominion Virginia Power, a Dominion subsidiary, sold a 3½-year extension of capped electricity rates to the General Assembly this year as a way to protect consumers from the failure of electric deregulation to produce competition.

Virginians may be happy with the extension, which will keep electric base rates - which do not include overall rate adjustments for fuel, reliability and environmental costs - at their mid-1990s levels through 2010.

Dominion, however, should do well under capped rates, too, increasing profit from 5 percent to 7 percent a year, Dominion executives said.

- Dominion can better increase its profit with frozen rates than it could under the old system of state-regulated rates, Chairman and CEO Thomas E. Capps said. "We've always made money when things freeze."

Thomas F. Farrell II, Dominion's president and chief operating officer, described the capped-rate extension as the last component needed for Dominion to become the most competitive and profitable integrated energy company in the country.

Dominion was earning an 11.5 percent return on shareholder equity in 1999 when rates were capped. It is earning 14 percent today because deregulation and capped rates caused the company to become more efficient and improve service, Farrell said. Uncertainty about rates has been eliminated through 2011, he said.

The capped-rate extension legislation also froze until mid-2007 the amount of power-plant fuel costs that Virginia Power can pass along to its customers. Fuel rates are frozen at $17.56 per megawatt hour, an all-time high, and any fuel savings boosts the bottom line.

Farrell enumerated several potential areas for savings. Dominion can reduce its costs for coal, which makes up 46 percent of its fuel costs, by negotiating favorable long-term contracts. The company can also increase the service time of its nuclear units from 91 percent to as much as 96 percent, which could add $20 million to earnings next year, he said.

Virginia Power - with no capital investment required - is making software changes in the way voltage is managed that could save up to $4 million a year by reducing the power lost through the transmission system, Farrell said.

Dominion is looking at up to $9 million in additional revenue from oil and coal sales at Tidewater facilities, and will use earnings from its oil and gas exploration and production business to offset

increases in the cost of fuel to generate electricity.

Virginia Power has cut by $160 million the annual amount it pays to independent power plants but still has contracts with independents that cost $580 million yearly. Since the passage of this year's legislation, the company has never been more active in cutting those costs, Farrell said.

Dominion will not see a higher profit until next year. This year, it expects less profit because of the frozen fuel rate. The company took a $20 million loss on unrecoverable fuel costs in the first three months of 2004 and expects to lose millions more on fuel through the rest of this year.

Farrell described the capped-rate law as a win for consumers and an opportunity, but no guarantee, for Dominion to increase profit. "We must perform," he said.

He said the company is not concerned about electric competition developing in Virginia and hopes it does.

Capps, responding to a question, said he does not expect the state legislature to change or reverse deregulation or seek a rate cut for power companies. Lawmakers have tried and failed before, and the legislature has been solidly behind competition for nearly a decade, he said.

It would take a big number of Virginians calling up their lawmakers to force a change in the law, he said. "That ain't going to happen," he said. "Nobody in Virginia is picking up the phone, writing a letter or sending e-mails complaining about electric rates because they've been flat since 1992."

In answer to another question, Capps indicated that Dominion may increase its dividend this fall. The dividend has not been raised in roughly a decade, but Capps indicated that Dominion's cash-flow situation may allow an increase.

Contact Greg Edwards at (804) 649-6390 or gedwards@timesdispatch.com

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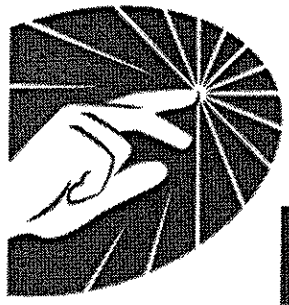


Dominion®

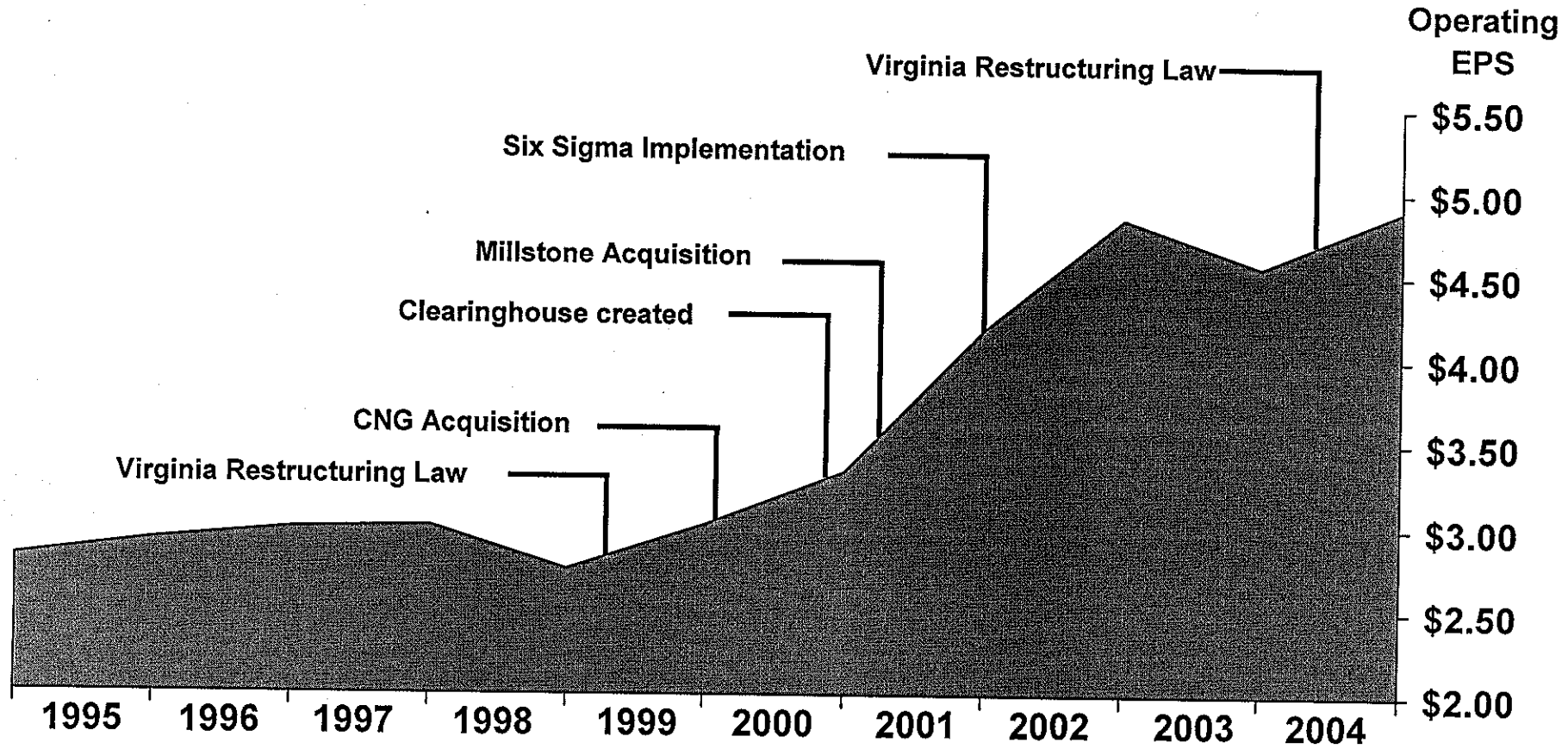
Spring 2004 Analyst Meeting

Update on Electric Deregulation in Virginia - SB 651

New York

May 6, 2004

Dominion's Got What it Takes



Dominion has consistently demonstrated earnings growth by building a balanced portfolio and developing competencies in operational, financial and risk management excellence. The latest Virginia Restructuring Law is one more piece of the strategic puzzle.

Dominion

Note: For a reconciliation of GAAP to non-GAAP financial measures, please go to our website at www.dom.com/investors under "GAAP Reconciliation".

Performance & Stability

- SB 651 opens doors to increased earnings
- The Rate Cap extension provides revenue certainty for additional 3 1/2 years
- Fixed fuel factor lowers Dominion's consolidated risk profile

Dominion

ATTACHMENT 4

Dominion Virginia Power's Request to Defer $280 Million of RTO Costs Until 2011

Dominion Virginia Power ("DVP") urged the General Assembly to amend the Virginia Electric Utility Restructuring Act by enacting SB 651, effective July 1, 2004. It argued that the bill would benefit its customers by freezing their rates at the current level and by imposing upon DVP all of the risks of new costs.

On May 11, 2004, however, DVP and the PJM Interconnection LLC ("PJM") filed with the Federal Energy Regulatory Commission ("FERC") a joint application to establish PJM South and transfer control of DVP's transmission assets to PJM. In the application, DVP asks FERC to permit it to defer approximately $280 million in costs that DVP estimates it will incur from seeking to join and joining a regional transmission organization ("RTO"). DVP argues in the application that it should be entitled to defer such costs and collect them after the expiration of the "capped rate" period in Virginia because "a state imposed rate cap will prevent Dominion from being able to recover any of the RTO-related costs."[1] The "capped rate" period is scheduled to end January 1, 2011. DVP further states that it should be entitled to defer and collect such costs from its customers because "Dominion is not eligible for any rate cases or any of the aforementioned rate adjustments. It is subject to the rate cap which became effective January 1, 2001, and which now will extend through December 31, 2010."[2]

Further, DVP states: "Given that RTOs provide significant customer benefits, it is appropriate for such customers to bear the associated costs of developing and participating in an RTO."[3] This statement is inconsistent, however, with the fact that "capped" base rates and frozen fuel rates prevent DVP's customers from receiving benefits from DVP joining the RTO, *i.e.*, benefits resulting from reduced fuel costs or avoidance of the need to build new generating units. With "capped" based rates and frozen fuel rates, DVP's shareholders, not it customers, will receive such benefits.

DVP should not be permitted to argue to the Virginia General Assembly that it is willing to bear the risk of all new costs during the "capped rate" period and, at the same time, argue to the FERC that, because of the "capped rates," it should be permitted to defer $280 million of RTO costs so that all such costs will be borne by its customers after the expiration of "capped rates."

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[1] Joint Application at 20.
[2] Joint Application at 21, fn. 45.
[3] Joint Application at 19.

ATTACHMENT 5

Presentation of Jeff Pollock
on behalf of the
Virginia Committee for Fair Utility Rates
and the
Old Dominion Committee for Fair Utility Rates
before the
Commission on Electric Utility Restructuring
November 24, 2003

Introduction

- Jeff Pollock is a principal with BAI (Brubaker & Associates). In his 29 years of practice in the utility industry, Mr. Pollock has participated in regulatory issues both in Virginia and in 19 other states, primarily in the southeast. He is especially active in Texas, which thus far has the most successful retail customer choice program in the nation.
- Mr. Pollock's firm, BAI, has been active in regulatory and legislative matters in many other states across the country. BAI has participated in or assisted over 30 other customer groups similar to the Old Dominion Committee for Fair Utility Rates (ODCFUR) and the Virginia Committee for Fair Utility Rates (VCFUR) in transitioning from regulation to customer choice.
- The Committees have retained BAI to render an opinion whether Appalachian Power Company (APCo) and Dominion Virginia Power Company (DVP) have stranded costs.
- As Mr. Pollock will explain, the short answer in both cases is a resounding NO!

Summary

- The purpose of our analysis is to determine whether APCo or DVP have stranded costs as a result of allowing retail competition. Our analysis reveals that neither

APCo nor DVP have stranded costs. Using a methodology first developed by Moody's Investors Service, a highly reputed firm that specializes in rating bonds and other securities, we have calculated that APCo would have $874 million of stranded benefits. Coupled with other evidence, we conclude that APCo does not have stranded costs.

- We obtained a similar result for DVP - $1.2 billion of stranded benefits – under the Moody's methodology. This study, coupled with the more detailed asset valuation presented to the State Corporation Commission and intervening changes, has led us to conclude that DVP does not have stranded costs.
- These results are based on the same 2003 market prices used by DVP and APCo and approved by the State Corporation Commission to set wires charges.
- We know that projected market prices for 2004 are significantly higher. Using these significantly higher market prices, stranded benefits would increase still further.
- Asset valuation is the appropriate method of administratively quantifying stranded costs. This was the approach used by DVP in a 1997 regulatory proceeding and used by VCFUR and the Attorney General in 1998. Further, the SCC Staff has recommended asset valuation. The Moody's methodology is another example of an asset valuation and it provides a "snapshot" of stranded costs.
- DVP's proposed method for quantifying stranded costs fails because, unlike an asset valuation, it doesn't compare book value with the market value of its generating assets over their remaining useful lives.
- Before elaborating further about our conclusions, allow me put our analysis in perspective.

Background on Stranded Cost

- The stranded cost debate arises in those states allowing retail customers to choose their electricity supplier. Stranded costs are *revealed* by retail competition because if customers can choose an alternative electricity supplier, the former regulated utility *might* not be able to fully recover the prudently incurred investments that it made under regulation.
- This is consistent with the definition of stranded costs in the State Corporation Commission's July 2003 Report to the Commission on Electric Utility Restructuring of the Virginia General Assembly, which I have adopted. Specifically, stranded cost is defined as the utility's net loss in economic value arising from electric generation-related costs that become unrecoverable due to restructuring and retail competition.
- In other words, unless customers switch from their current regulated suppliers, stranded costs are zero. Without suppliers vigorously competing for retail business, there can be no competition, and without competition, there can be no customer choice, and therefore, no stranded costs.
- In Virginia, to date, only very few customers have switched suppliers. Therefore, even though current law allows retail competition for all customers, no costs have been stranded. Despite this fact, DVP has been allowed to accumulate hundreds of millions of dollars in excess earnings for the sole purpose of stranded cost recovery.
- The irony here is that the longer it takes before all retail customers switch suppliers, the less likely a utility will incur stranded costs. At the earliest, significant switching will not begin until July 1, 2007, when wires charges expire and all customers must pay market prices.

Definition and Quantification of Stranded Cost

- As mentioned previously, BAI has been involved in many states during the transition from regulation to customer choice. Although each state has approached the stranded cost issue somewhat differently, we have learned that there are appropriate and reasonable methods of quantifying stranded costs.
- Though concerns have been raised that quantifying stranded costs requires making assumptions, many of the key variables used in a conventional asset valuation can be fully vetted. For this reason, regulators in customer choice states have been empowered to determine stranded costs for their regulated utilities in contested proceedings. The good news is that the SCC need not begin from scratch. There is a wealth of experience and regulatory precedent that can be used to quantify stranded costs in the Commonwealth.
- First, we can agree that stranded cost is the difference between the regulatory book value and the corresponding market value of a utility's generation fleet. If the market value exceeds book value, then a utility is said to have stranded benefits.
- Second, determining book value is relatively easy. The more challenging task is quantifying the market value. This process is no different in principle from a conventional asset valuation. Asset valuation is widely used by appraisers, financial analysts, investors, and consumers.
- Asset valuation is not rocket science. In an asset valuation, we calculate the net present value of the free cash flows (that is, future revenues less future cash expenses) derived from the use of the assets over their remaining useful lives.

- DVP used similar valuation techniques in the "Transition Cost Report," which it filed with the SCC in 1997. DVP is also using these techniques to conduct asset impairment tests for financial reporting purposes.
- The Moody's approach to valuing utility assets and determining whether a utility is likely to have stranded costs, which I have used in my analysis presented here, is an excellent example of a simplified, but reasonably accurate, asset valuation technique. It is a snapshot based on current conditions.
- The "Moody's" methodology uses publicly available data to determine whether the regulatory net book value of generation assets can be sustained in a competitive market environment. The analysis also takes into account reported payments made to independent third parties for purchased power and any remaining regulatory assets.
- Using the Moody's methodology, we calculated that APCo and DVP would have stranded benefits of $874 million and $1.2 billion, respectively. There is, however, other evidence to support our conclusions that neither utility has stranded costs.

APCo

- First, with respect to APCo, not only does APCo enjoy very low rates, APCo has not asked the SCC to implement a wires charge under the Act.
- APCo's rates are the lowest for industrial customers in the southeast. A recent BAI survey of industrial electricity rates revealed that APCo ranks 28th out of 30 utilities in the Southeast, where 1 is most expensive and 30 is the least expensive. The survey includes investor-owned utilities and the TVA.

- Wires charges, along with capped generation rates, are the tools through which utilities are allowed stranded cost recovery under the Act.
- A wires charge is the amount of revenue that APCo would lose if customers were to switch suppliers. It is the difference between capped generation rates and the current market price.
- A zero wires charge means that market prices are higher than the capped rates. In other words, there are no stranded costs, only stranded benefits for APCo.

DVP

- The results we obtained for DVP comport with a prior study that was filed by DVP in a 1997 regulatory proceeding before the SCC. I am referring to the Transition Cost Report.
- The Transition Cost Report was an in-depth and detailed asset valuation. DVP determined the market value of its entire generation fleet, along with its substantial NUG purchases, to quantify potentially stranded costs. Based on its analysis, DVP contended that it would have $2.5 billion of potentially stranded costs.
- BAI conducted an in-depth analysis of the DVP study and in particular the underlying assumptions. We were very impressed with the detail and thoroughness of the study. DVP's asset valuation study estimated the free cash flows from the generation fleet operating in fully competitive markets through 2015. It was in nearly all respects a bona fide asset valuation.
- One of DVP's key assumptions was that competitive suppliers would serve all customers on January 1, 2003 – a fact we know today to be wrong. Ignoring this obvious hindsight, our analysis revealed several major flaws.

- Correcting only two of these flaws, and using DVP's method otherwise, my firm determined that DVP would have $2.7 billion of stranded benefits.
- The two major flaws that we corrected to arrive at the opposite conclusion as DVP were:
  - Employing a cut-off date of 2035, rather than 2015, to recognize the fact DVP's generation fleet will have many years of useful life beyond 2015.
  - Using a capacity value that would encourage competition.
- By prematurely cutting off the study at 2015, DVP failed to fully capture the much greater market value of its generating assets during a period when they would generate the most profit.
- Undervaluing capacity means understating the cost of maintaining reliability. We would all agree that maintaining reliability is critical regardless of the regulatory environment.
- Despite the 1997 vintage of the DVP study and our two corrections to it, the conclusions would be the same if a similar study were conducted today – DVP has no stranded costs. Consider the following:
  - Market prices for electricity are much higher than the Company assumed due to higher natural gas prices. This increases the market value of DVP's generation fleet, thereby reducing any potential stranded costs and increasing stranded benefits.
  - DVP has extended the lives of its nuclear plants by 20 years. This will reduce costs under capped generation rates (due to lower depreciation expense). Further, the Company will be able to profit handsomely in competitive markets

because the operating cost of a nuclear plant is 15% or less of the wholesale market price of electricity. This would further increase stranded benefits.

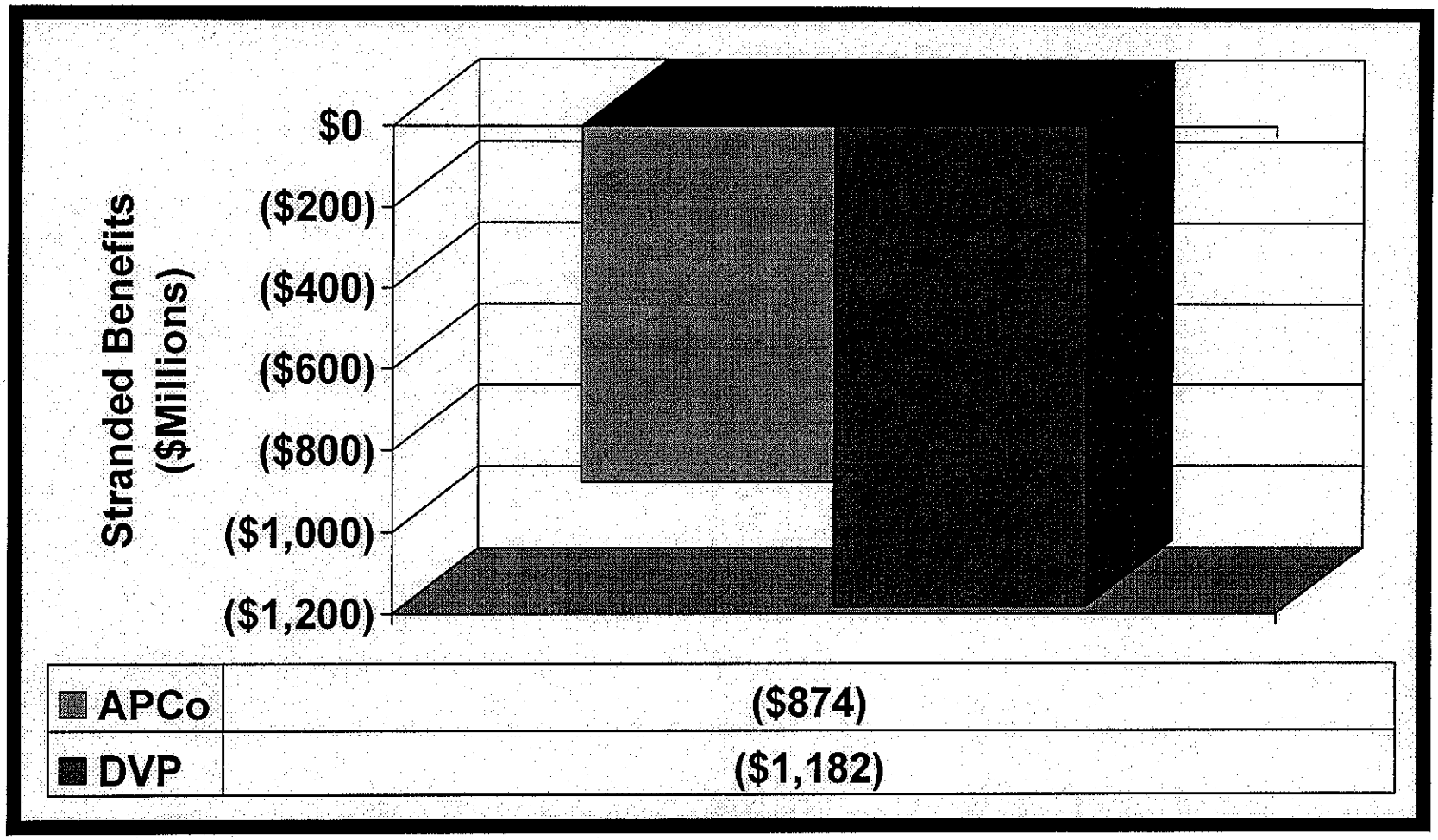
- The Company has renegotiated several of its NUG contracts, and several contracts have expired since 1998. As a result of the passage of time, the Company's commitment under purchased power contracts is about $1 billion lower on a net present value basis.

- Finally, as I previously stated, DVP is using asset valuation techniques for financial reporting purposes to determine whether it will have to write-off investment or recognize losses under its purchased power contracts. Thus far, the Company has not had to write down any plant investment or recognize any contract losses. In essence, the Company is conceding, based on its own assessment of future market prices, that it has no stranded costs.

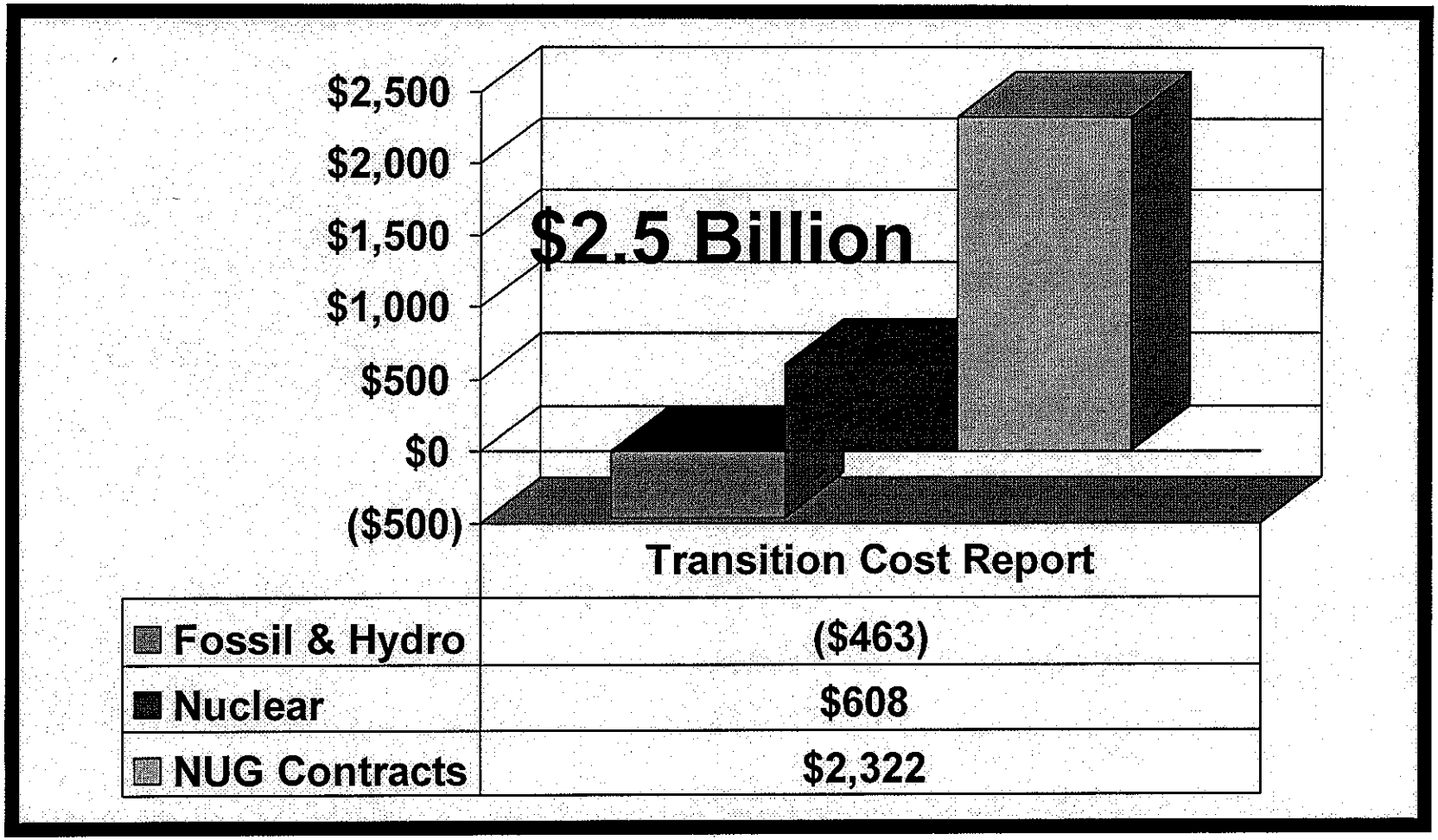
Stranded Cost Summary

- **No evidence that either APCo or DVP have stranded costs**
- **Asset valuation is the appropriate methodology**
  - **Used by DVP in 1997 ($2.5 Billion stranded cost)**
  - **Used by Attorney General in 1998 ($1.3 Billion stranded benefits)**
  - **Used by VCFUR in 1998 ($2.7 Billion stranded benefits)**
  - **Recommended by the SCC Staff**
  - **Used by Moody's ("snapshot")**

Estimated Stranded Costs Using Moody's Methodology



1997 Transition Cost Report
DVP Analysis



Estimated Stranded Costs (Benefits) With VCFUR Corrections